Testimony

of

Mary L. Schapiro

NASD Vice Chairman and President
Regulatory Policy and Oversight

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the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
House Financial Services Committee

Hearing on Mutual Fund Trading Abuses

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Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to submit this written statement for the record. NASD strongly supports H.R. 2420, the Mutual Funds Integrity and Fee Transparency Act of 2003.

NASD

NASD, the world's largest securities self-regulatory organization, was established in 1939 under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. Every broker/dealer in the U.S. that conducts a securities business with the public is required by law to be a member of NASD. NASD's jurisdiction covers nearly 5,400 securities firms that operate more than 92,000 branch offices and employ more than 665,000 registered securities representatives.

NASD writes rules that govern the behavior of securities firms, examines those firms for compliance with NASD rules, MSRB rules, and the federal securities laws, and disciplines those who fail to comply. Last year, for example, we filed a record number of new enforcement actions (1,271) and barred or suspended more individuals from the securities industry than ever before (814). Our investor protection and market integrity responsibilities include examination, rulewriting and interpretation, professional training, licensing and registration, investigation and enforcement, dispute resolution, and investor education. We monitor all trading on The NASDAQ Stock Market -- more than 70 million orders, quotes, and trades per day. NASD has a nationwide staff of more than 2,000 and is governed by a Board of Governors at least half of whom are unaffiliated with the securities industry.

NASD's involvement with mutual funds is predicated on our authority to regulate broker/dealers. NASD does not have any jurisdiction over investment companies or the fund's investment adviser; rather, we regulate the sales practices of broker/dealers who sell the funds to investors. Our investor education efforts also place special emphasis on mutual funds due to their widespread popularity with investors.

Our examination and enforcement focus in this area has concentrated on five main areas: first, the suitability of the mutual funds that brokers are selling; second, broker sales practices; third, the disclosures provided to investors; fourth, the compensation arrangements between the funds and brokers; and, fifth whether brokers are delivering to their customers the benefits to which they are entitled, such as breakpoint discounts. We have brought some 60 enforcement cases this year in the mutual fund area, and more than 200 over the last three years. We also have a number of ongoing examinations and investigations involving mutual fund issues, including late trading and market timing.

NASD Strongly Supports H.R. 2420

NASD strongly supports H.R. 2420. Indeed, in those areas where NASD has jurisdiction, we have already begun the rulemaking process to implement some of the principles of H.R. 2420. Sections 2 and 12 of H.R. 2420 would require mutual funds and brokers to provide extensive information on mutual fund expenses and conflicts of interest,

including sales compensation and revenue sharing arrangements. NASD strongly supports the goals of these provisions, and commits itself to working with Congress and the SEC to ensure that they are implemented in a manner that best serves fund shareholders.

NASD already has taken action in this area. In September, NASD proposed to require that broker/dealers provide investors with information about revenue sharing arrangements; that is, payments made by the Fund Adviser to the broker-dealer for "shelf space." We also proposed to require similar disclosure concerning "differential compensation" arrangements, which are cash compensation payments by a broker/dealer to a registered representative that are designed to favor one fund product, such as the broker/dealer's proprietary mutual funds, over another. Our proposal would require disclosure of the mutual fund companies that are the subject of these arrangements, when a customer opens an account and on a semi-annual basis thereafter. The comment period on the proposal recently ended and we expect to file with the SEC soon.

We similarly support the requirement in Section 7 that the SEC or an SRO adopt a rule clarifying the definition of the term "no-load fund," so that investors better understand the term. NASD Rule 2830(d)(4) allows the advertisement of a fund as "no-load" only if the fund imposes no front-end or deferred sales load, and does not impose a 12b-1 fee or service fee that exceeds 0.25% per annum.

The NASD rule was intended to ensure that investors do not purchase a so-called "no load" fund that in fact charges high 12b-1 or other sales-related fees. We do permit broker/dealers to earn a fee of 25 basis points for servicing a customer's account and answering questions about the fund without having to refer to the fund as a load fund. Of particular concern is the fact that while NASD can limit the fees that a *broker/dealer* receives for selling a no-load fund, we cannot limit the fees that the fund's investment adviser receives. Consequently, no-load funds may pay significant adviser fees and other expenses. We agree that a more comprehensive review by the SEC and NASD would be constructive. We look forward to working with the Subcommittee and SEC on this important issue.

We also look forward to working with the Subcommittee and the SEC on technical issues that may arise as H.R. 2420 moves forward and the SEC proceeds with rulemaking to implement the provisions of H.R. 2420.

Recent Enforcement Efforts

NASD has several rules that govern the relationship between broker/dealers and fund companies. For example, our rule governing cash and non-cash compensation, Rule 2830, generally prohibits the award of non-cash compensation, such as lavish trips and entertainment, to brokers for the sale of mutual fund shares. The rule thus prohibits contests that encourage brokers to steer their customers into unsuitable investments. The rules are designed to prevent the conflicts of interest that may arise for the broker when faced with such a choice.

Cash and Non-Cash Compensation Cases

In September, we brought a case under this rule against Morgan Stanley that resulted in a $2 million fine against the firm. Morgan Stanley had been conducting prohibited sales contests for its brokers and managers to push the sale of Morgan Stanley's own proprietary mutual funds. In addition to censuring and fining the firm, NASD also censured and fined a senior member of the firm's management – the head of retail sales.

Between October 1999 and December 2002, the firm had conducted 29 contests and offered or awarded various forms of non-cash compensation to the winners, including tickets to Britney Spears and Rolling Stones concerts, tickets to the NBA finals, tuition for a high-performance automobile racing school, and trips to resorts.

The obvious danger of such contests is that they give firm personnel a powerful incentive to recommend products that serve the broker's interest in receiving valuable prizes, rather than the investment needs of the customer. And one of the most troubling things about this case is Morgan Stanley's failure to have any systems or procedures in place that could detect or deter the misconduct.

In January 2003, NASD censured and fined IF Distributor, Inc., and VESTAX Securities Corp. a total of $150,000 for failing to disclose special cash compensation they paid to their sales force in the sale of mutual fund shares. Prior to disclosing this special cash compensation, the reps sold over $20 million in Class A shares to over 200 customers. Brokers selling these shares received approximately $220,000 in special cash compensation.

NASD Rule 2830

We also are conducting an examination sweep where we are looking at more than a dozen broker/dealers, specifically with a view to determine how investment companies pay for inclusion on firms' featured mutual fund list or why they receive favored promotional or selling efforts. We are looking at different types of firms, including full-service, discount and online broker/dealers. Thousands of funds are presented to investors through discount and on-line broker-dealer "supermarkets." In addition, we are examining a similar number of mutual fund distributors, who are also our members. Mutual fund sponsors and distributors that once marketed exclusively through a single, traditional distribution channel often now compete head-to-head in the same distribution channels vying for visibility and valuable "shelf space." We want to see what the distributors' role may be in these types of practices.

At issue in this sweep is NASD Rule 2830, which expressly prohibits members from directly or indirectly, favoring or disfavoring the sale of shares of any investment company or group of investment companies on the basis of brokerage commissions received or expected by that member from any source. In short, an NASD member cannot seek brokerage commissions from a fund or investment company as a condition to the sale or distribution of investment company securities. Exchanging prominent placement of a

fund or family of funds on a firm's Web site or in the firm's marketing material or placing a fund on a "featured" or "preferred" list of funds in exchange for brokerage commissions from the fund may be misleading to investors and a violation of NASD rules.

Class B Shares

Many mutual funds offer different classes of the same investment portfolio. Each class is designed to provide brokers and their customers with a choice of fee structure. Class A mutual fund shares charge a sales load when the customer purchases shares. Class B shares do not impose such a sales charge. Instead, Class B shares typically impose higher expenses that investors are assessed over the lifetime of their investment. Class B shares also normally impose a contingent deferred sales charge (CDSC), which a customer pays if the customer sells the shares within a certain number of years. In addition, investors who purchase Class B shares cannot take advantage of breakpoint discounts available on large purchases of Class A shares.

NASD has found that some brokers have unscrupulously recommended Class B shares in such large amounts that the customer would have qualified for breakpoint discounts had the broker recommended Class A shares instead. Some brokers also have recommended transactions in Class B shares that are so frequent as to cause the customer to incur CDSC charges. In both cases, the broker may receive higher compensation for the Class B recommendations. NASD has vigorously prosecuted these violations, and we are continuing a comprehensive review of Class B shares sales practices. Over the last two years, NASD has brought more than a dozen enforcement actions against firms and individual brokers for these types of violations.

For example, in May the SEC affirmed a disciplinary action NASD took against Wendell D. Belden, who was found to have violated NASD's suitability rule by recommending that a customer purchase Class B mutual fund shares in five different mutual funds within two fund families instead of Class A mutual fund shares. Because of the size of his customer's investment ($2.1 million) and the availability of breakpoint discounts for Class A shares, Belden's recommendations caused his customer to incur higher costs, including contingent deferred sales charges.

Belden tried to justify his recommendations to customers that they purchase the Class B shares instead of the Class A shares because he received greater commissions on the sales of these shares. He stated that he "couldn't stay in business" with lower commissions. Belden was fined, suspended, and ordered to pay more than $50,000 back to his customers.

In June we announced a settled action against McLaughlin, Piven, Vogel for violations in this area. The firm was fined $100,000 and ordered to pay restitution of approximately $90,000 to 21 customers. In August we announced five more actions for unsuitable sales of Class B shares.

Breakpoints

Mutual funds typically offer discounts to the front-end sales load assessed on Class A shares at certain pre-determined levels of investment, which are called "breakpoints." The extent of the discount is based on the dollar size of the investor's investment in the mutual fund. For example, breakpoint discounts may begin at dollar levels of $25,000 (although, more typically, at $50,000) and increase at $100,000, $250,000, $500,000, and $1,000,000. At each higher level of investment, the discount increases, until the sales charge is eliminated.

An investor can become entitled to a breakpoint discount to the front-end sales charge in a number of ways. First, an investor is entitled to a breakpoint discount if his single purchase is equal to or exceeds the specified "breakpoint" threshold. Second, mutual funds generally allow investors to count future purchases toward achieving a breakpoint if the investor executes a letter of intent that obligates him to purchase a specified amount of fund shares in the same fund or fund family within a defined period of time. Similarly, mutual funds generally grant investors "rights of accumulation," which allow investors to aggregate their own prior purchases and the holdings of certain related parties toward achieving the breakpoint investment thresholds (including reaching investment thresholds necessary to satisfy letters of intent).

Mutual fund families began to offer these breakpoint discounts to make their funds more attractive to investors. Over time, funds expanded the rights of accumulation they offered by expanding the categories of accounts that could be linked or aggregated for the purpose of obtaining breakpoint discounts. Mutual funds view their aggregation rules as important competitive features of their products. Accordingly, these rights of accumulation can vary from fund family to fund family, and many fund families define the related parties that can aggregate their holdings to determine breakpoint discount eligibility differently. For instance, one fund family may allow parents to link their accounts with a "minor child," while another fund family may allow parents to link their accounts with any child residing at home.

During routine examinations of broker-dealers by our Philadelphia District Office, NASD discovered that broker-dealers selling front-end load mutual funds were not properly delivering breakpoint discounts to investors. Following this discovery, in November and December 2002, the SEC and New York Stock Exchange joined us for an examination sweep of 43 firms selling front-end load mutual funds. We found that most of those firms did not give investors all the breakpoint discounts they should. Failures to give the discounts stemmed from a variety of different operational problems, including a failure to link share classes and holdings in other funds in the same fund family and a failure to link accounts of family members.

NASD issued a *Notice to Members* on December 23, 2002, reminding firms to explain and deliver breakpoints. And, we issued in January 2003 an Investor Alert to advise customers of breakpoint opportunities.

Also in January 2003, the SEC asked NASD to lead a task force to find breakpoint solutions. The task force had 24 members, including representatives from broker/dealers, mutual funds, transfer agents, clearing facilities, academia, the SEC staff, other SRO's and trade associations.

The Task Force issued its report in July 2003, in which it recommended a number of technological and operational changes, as well as modifications to mutual fund prospectus and other disclosure and sales practices, to ensure that customers are not overcharged. Working groups, consisting of knowledgeable representatives of the mutual fund and securities industries, are currently engaged in implementation of the Task Force recommendations. NASD and the SEC receive periodic reports from these Working Groups and are monitoring progress as implementation moves forward.

H.R. 2420 Section 2(a)(6) is right on target by requiring disclosure of breakpoint schedules and the persons who are eligible for breakpoints. The Task Force recommendations echo this by calling on the SEC and NASD to require mutual funds and broker/dealers to provide information to investors to ensure that investors get the breakpoints to which they are entitled.

As for the transactions that should have received discounts, NASD supplemented its referenced examination effort with a survey of every NASD member to learn more about each member's overall mutual fund activities. The survey, in turn, provided NASD with information that helped us frame a self-assessment. Specifically, NASD directed firms to perform a self-assessment of their own of breakpoint discounts delivery. These self-assessments were carried out through use of a carefully constructed sample of transactions, which permitted NASD to extrapolate each firm's performance to its entire universe of transactions. NASD has concluded that, during the 2001 to 2002 period covered by the self-assessments, investors were overcharged in about one out of every five transactions in which they were eligible for breakpoint discounts. Those overcharges, in our view, total at least $86 million, and the average overcharge was $243. When the assessments were complete, firms were directed to refund overcharges to investors, with interest. In addition, NASD will require that most of the firms involved undertake further action, including contacting their customers individually to alert them to possible overcharges. Disciplinary or enforcement proceedings will be brought against certain of the firms.

Late Trading and Market Timing

Investment Company Act Rule 22(c)(1) generally requires that mutual fund shares be sold and redeemed at a price based on the net asset value (NAV) of the fund computed after the receipt of the order. In practice this requirement means that mutual fund shares are priced according to the value of their securities portfolio, computed at the next close of the national securities exchanges. For example, if a mutual fund receives an order to purchase shares before the close of the securities exchanges, 4 p.m. EST, the investor should receive a price based on that 4 p.m. close. If, however, a mutual fund receives an order to purchase shares after the 4 p.m. close, the investor should receive a price based on *the next day's* 4 p.m. close. This "forward pricing" requirement represents a fundamental

principle of the Investment Company Act, for it prevents investors who might have access to the NAV of the portfolio from trading on that information.

The failure to meet the forward pricing standard has become known as "late trading." Late trading, however, should be distinguished from the practice, followed by many broker/dealers and other intermediaries of transmitting orders after 4 p.m. because they require additional processing time. For example, some intermediaries may net out transactions by pension plan participants in order to simplify their order to the mutual fund company. In these instances, the participants entered their orders before or at 4 p.m., but the orders of the plan were not processed and transmitted until after 4 p.m.

The frequent trading of mutual fund shares in order to take advantage of pricing inefficiencies or market movements has become known as "market timing." Market timing is not per se illegal. Market timing activities become illegal when they violate the fiduciary duty of the fund's investment adviser; they also are problematic when they violate a stated policy of the fund as disclosed in the fund's prospectus. Many mutual funds police market timing by their shareholders, because market timing can increase fund expenses and harm fund performance for the other shareholders. When a mutual fund has disclosed a policy of protecting investors from market timers, a broker/dealer may not knowingly or recklessly collude with the fund in order to effect a market timing transaction. Broker/dealers must have in place policies and procedures reasonably designed to detect and prevent this collusion.

In response to prevailing issues concerning mutual fund execution, in September NASD sought information from roughly 160 firms regarding late trading and impermissible market timing.

As a preliminary matter, we have determined that numerous firms' conduct warranted a referral to NASD's Enforcement Department for further investigation and possible disciplinary action. Another group of firms are being examined by our Member Regulation Department for potential late trading and impermissible market timing misconduct.

Specifically, a number of firms disclosed that they had, or probably had, received and entered mutual fund orders after U.S. markets closed for the day. Some of these firms disclosed specifically that they had accepted and entered late trades; other firms disclosed that they "probably" accepted and entered late trades. This imprecision in the latter group indicates separate issues of poor internal controls and record keeping; we will also pursue these areas. These matters, too, have been referred to NASD's Enforcement Department for action.

NASD also has identified a number of firms that were involved in market timing and it remains to be determined whether their activities were impermissible under our rules or applicable statutes. These firms appear to have facilitated a customer's market timing strategy in mutual funds or variable annuities, had employees who agreed with a mutual fund or variable annuity to market time the issuer's shares, or had an affiliate involved in

some form of market timing of mutual funds or variable annuities. We are investigating any broker/dealer that made any of these disclosures in our investigations. We will investigate whether these firms simply allowed market timing, which is not per se illegal, or whether they colluded with the mutual fund companies to evade the fund's stated policies against market timing.

Investor Education

Mutual funds have been a particular focus of NASD's investor education efforts. This year alone, we have issued Investor Alerts on:

- Mutual fund share classes
- Mutual fund breakpoints
- Principal protected funds
- Class B mutual fund shares

Each of these Investor Alerts educates investors about the wide variety of mutual fund fee structures that exist and urges investors to scrutinize mutual fund sales charges, fees, and expenses.

Research has shown that many investors are unaware of how much they pay to own mutual funds and that even small differences in fees can result in thousands of dollars of costs over time that could have been avoided. To help investors make better decisions when purchasing mutual funds, we have unveiled an innovative "Mutual Fund Expense Analyzer" on our Web Site. Unlike other such tools, the Expense Analyzer allows investors to compare the expenses of two funds or classes of funds at one time, tells the investor how the fees of a particular fund compare to industry averages, and highlights when investors should look for breakpoint discounts. To make this tool more widely available to investors, we are developing a version of the Expense Analyzer for broker/dealer Web sites.

Conclusion

NASD commends the Committee for its work on H.R. 2420 and stands ready to help as the bill moves through the House. We applaud your efforts to bring increased transparency to the mutual fund industry and will continue to do our part in this area as well. NASD will continue its vigorous examination and enforcement focus on the suitability of the mutual fund share classes that brokers are selling, the compensation practices between the funds and brokers, and the question of whether brokers are delivering to their customers the benefits offered to them, such as breakpoint discounts. And as we continue our examinations and investigations into late trading and market timing issues, we will enforce NASD rules with a full range of disciplinary options-- which include stiff fines, restitution to customers and the potential for suspension or expulsion from the industry. While NASD cannot alone solve all the problems revealed in recent months in the mutual fund industry, we have jurisdiction over all broker/dealers that sell these products to investors and will rigorously exercise our authority to take actions against

violators as part of our overall efforts to protect investors and to restore investor confidence.